9 Income From Rents and Royalties

Use Schedule E to report real estate rental income and expenses. You must also file Form 4562 to claim depreciation deductions for buildings you acquired in 1996.

Use Schedule C instead of Schedule E if you provide additional services for the convenience of the tenants, such as maid service. That is, Schedule C is used to report payments received for the use and occupancy of rooms or other areas in a hotel, motel, boarding house, apartment, tourist home, or trailer court where services are provided primarily for the occupant.

If you rent an apartment or room in the same building in which you live, you report the rent income less expenses allocated to the rental property; *see* ¶9.4.

The law prevents most homeowners from deducting losses (expenses in excess of income) on the rental of a personal vacation home or personal residence if the owner or close relatives personally use the premises during the year. Tests based on days of personal and rental use determine whether you may deduct losses as explained in ¶9.7.

Rental losses may also be limited by the passive activity rules of Chapter 10. Real estate professionals may avoid passive restrictions on rental income, and an investor who actively manages property may deduct rental losses of up to $25,000.

Use Schedule E to report royalties, but if you are a self-employed author, artist, or inventor, report royalty income and expenses on Schedule C.

Business rentals of equipment, vehicles, or similar personal property are reported on Schedule C, not Schedule E.

Rental Income and Deductions

¶9.1 Reporting Rental Income and Expenses

On the cash basis, you report rent income on your tax return for the year in which you receive payment or in which you "constructively" receive it, such as where payment is credited to your bank account.

On the accrual basis, you report income on your tax return for the year in which you are entitled to receive payment, even if it is not actually paid. However, you do not report accrued income if the financial condition of the tenant makes collection doubtful. If you sue for payment, you do not report income until you win a collectible judgment.

Advance rentals. Advance rentals or bonuses are reported in the year received, whether you are on the cash or accrual basis.

Tenant's payment of landlord's expenses. The tenant's payment of your taxes, interest, insurance, mortgage amortization (even if you are not personally liable on the mortgage), repairs, or other expenses is considered additional rental income to you. If your tenant pays your utility bills or your emergency repairs and deducts the amount from the rent payment, you must include as rental income the full rental amount, not the actual net payment. However, you can claim an offsetting deduction for expenses, such as repairs, that would have been deductible had you paid them.

Tenant's payment to cancel lease. A tenant's payment for cancelling a lease or modifying its terms is considered rental income in the year you receive it regardless of your method of accounting. You may deduct expenses incurred because of the cancellation or modification and any unamortized balance of expenses paid in negotiating the lease.

Insurance. Insurance proceeds for loss of rental income because of fire or other casualty are rental income.

Security Deposits

Distinguish advance rentals, which are income, from security deposits, which are not. Security deposits are amounts deposited with you solely as security for the tenant's performance of the terms of the lease, and as such are usually not taxed, particularly where local law treats security deposits as trust funds. If the tenant breaches the lease, you are entitled to apply the sum as rent, at which time you report it as income. If both you and your tenant agree that a security deposit is to be used as a final rent payment, it is advance rent. Include it in your income when you receive it.

Improvements by tenants. You do not realize taxable income when your tenant improves the leased premises, provided the improvements are not substitute rent payments. Furthermore, when you take possession of the improvements at the time the lease ends, you do not realize income. However, you may not depreciate the value of the improvements as the basis to you is considered zero.

Property or services. If you receive property or services instead of money, include the fair market value of such property or services as rental income.

If you agree upon a specified price for services rendered, that price is generally treated as the fair market value.

Rental losses. Rental income may be offset by deductions claimed for depreciation, mortgage interest, and repair and maintenance costs. However, if these expenses exceed rental income, the resulting loss is subject to deduction limitations. If you do not qualify as a real estate professional (¶10.3), you generally may not deduct rental losses from other income (such as salary, interest, and dividends). Rental losses may offset only other rental and passive activity income. However, if you perform some management role, you may deduct from other income *real estate* rental losses of up to $25,000, provided your adjusted gross income does not exceed $100,000. The passive activity restrictions have the positive effect of making rental income attractive. Consider purchasing rental property if you have passive tax losses which may be used to offset the rental income.

Passive loss restrictions, which also affect tax credits, are discussed in Chapter 10.

¶9.2 Checklist of Rental Deductions

The expenses in this section are deductible from rental income on Schedule E of Form 1040 in determining your profit.

Real estate taxes. However, special assessments for paving, sewer systems, or other local improvements are not deductible; they are added to the cost of the land. *See* ¶16.6 through ¶16.9 for real estate tax deductions.

Construction period interest and taxes. These expenses generally have to be capitalized and depreciated; *see* ¶16.5.

Depreciation of a rental building. You may start claiming depreciation in the month the building is ready for tenants. For example, you bought a house in May 1996 and spent June and July making repairs. The house is ready to rent in August and you advertise for tenants. You begin depreciation as of August, even if a tenant does not move in until September or some later month. The month the building is ready for tenants is the month that determines the first-year depreciation write-off under the mid-month convention. *See* ¶9.5 for the monthly-based depreciation rates.

Depreciation for furniture and appliances. Furniture used in your rental property, carpeting, and appliances such as stoves and refrigerators are considered seven-year property under MACRS; *see* ¶42.4. The seven-year recovery period also applies to office furniture and equipment such as desks and files.

Management expenses.

Maintenance expenses, such as heating, repairs, lighting, water, electricity, gas, telephone, coal, and other service costs; *see* ¶9.3.

Salaries and wages paid to superintendents, janitors, elevator operators, and service and maintenance personnel.

Traveling expenses to look after the properties. If you travel "away from home" to inspect or repair rental property, be prepared to show that this was the primary purpose of your trip, rather than vacationing or other personal purposes. Otherwise, the IRS may disallow deductions for round-trip travel costs.

Legal expenses for dispossessing tenants. But expenses of long-term leases are capital expenditures deductible over the term of the lease.

Interest on mortgages and other indebtedness. But expenses and fees for securing loans are nondeductible capital expenditures.

Commissions paid to collect rentals. But commissions paid to secure long-term rentals must be deducted over the life of the lease. Commissions paid to acquire the property are capitalized.

Premiums for fire, liability, and plate glass insurance. If payment is made in one year for insurance covering a period longer than one year, you amortize and deduct the premium over the life of the policy, even though you are on a cash basis.

Also deductible is a premium paid to secure a release from a mortgage in order to get a new loan.

Tax return preparation. You may deduct as a rental expense the part of a tax preparation fee allocable to Part 1 of Schedule E (income or loss from rentals or royalties). You may also deduct, as a rental expense, a fee paid to a tax consultant to resolve a tax underpayment related to your rental activities.

Charging below fair market rent. If you rent your property to a friend or relative for less than the fair rental value, you may deduct expenses and depreciation only to the extent of the rental income; *see* ¶9.8.

Co-tenants. One of two tenants in common may deduct only half of the maintenance expenses although he or she pays the entire bill. A tenant in common who pays all of the expenses of the common property is entitled to reimbursement from the other co-tenant. So one-half of the bill is not his or her ordinary and necessary expense. Each co-tenant owns a separate property interest in the common property which produces separate income for each. Each tenant's deductible expense is that portion of the entire expense which each separate interest bears to the whole, and no more.

COURT DECISION

Co-Tenant's Deduction for Real Estate

The Tax Court allowed a co-tenant to deduct more than her proportionate share of real estate taxes. According to the court, the deduction test for real estate taxes is whether the payment satisfied a personal liability or protects a beneficial interest in the property. In the case of co-tenants, nonpayment of taxes by the other co-tenants could result in the property being lost or foreclosed. To prevent this, a co-tenant who pays the tax is protecting his or her beneficial interest and, therefore, is entitled to deduct the payment of the full tax.

Costs of cancelling lease. A landlord may pay the tenant to cancel an unfavorable lease. The way the payment is treated by the landlord depends on the reason for the cancellation. If the purpose of the cancellation is to enable the landlord to construct a new building in place of the old, the cancellation payment is added to the basis of the new building. If the purpose is to sell the property, the payment is added to the cost of the property. If the landlord wants the premises for his or her own use, the payment is deducted over the remaining term of the old lease. If the landlord gets a new tenant to replace the old one, the cancellation payment is also generally deductible over the remaining term of the old lease.

EXAMPLE

Handlery Hotels, Inc., had to pay its lessee $85,000 to terminate a lease on a building three years before the lease term expired. Handlery entered into a new 20-year lease at more favorable terms with another lessee. Handlery amortized the $85,000 cancellation payment over the three-year unexpired term of the old lease. The IRS claimed that the payment had to be amortized over the 20-year term of the new lease because it was part of the cost of obtaining the new lease. A federal district court agreed with the IRS, but an appeals court sided with Handlery. Since the unexpired lease term is the major factor in determining the amount of the cancellation payment, the cost of cancellation should be amortized over that unexpired term.

¶9.3 Distinguishing Between a Repair and an Improvement

Maintenance and repair expenses are not treated in the same way as expenses for improvements and replacements. Only maintenance and incidental repair costs are deductible against rental income. Repairs that add to the value or prolong the life of the property or adapt the property to new uses are capital improvements. Capital

improvements may not be deducted currently but may be depreciated under the rules at ¶42.13. If you make improvements to property before renting it out, add the cost of the improvements to your basis in the property.

A repair keeps your property in good operating condition. For example, repairs include painting, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows. However, putting a recreation room in an unfinished basement, paneling a den, putting up a fence, putting in new plumbing or wiring, putting on a new roof, and paving a driveway are all examples of capital improvements depreciable under ¶42.13.

Repairs may not be separated from capital expenditures when part of an improvement program; *see* Example 2 below.

EXAMPLES

1. The costs of painting the outside of a building used for business purposes and the costs of papering and painting the inside are repair costs and may be deducted. The replacement of a roof or a change in the plumbing system is a capital expenditure which may be depreciated under MACRS; *see* ¶42.13.
2. Amanda Jones buys a dilapidated business building and has the building renovated and repaired. The total cost comes to about $130,000, of which $17,800 is deducted as repairs. But the repair deduction is disallowed because it is a capital expenditure. When a general improvement program is undertaken, you may not separate repairs from improvements. They become an integral part of the overall betterment and a capital investment, although they could be characterized as repairs when viewed independently.

What if the repairs and improvements are unconnected and not part of an overall improvement program? Assume you repair the floors of one story and improve another story by cutting new windows. You may probably deduct the cost of repairing the floors provided you have separate bills for the jobs. To safeguard the deduction, schedule the work at separate times so that the two jobs are not lumped together as an overall improvement program.

Normal maintenance or major improvement? Normal maintenance expenses were distinguished from major improvement costs in a case involving a major hotel where improvements and maintenance were generally done at the same time. The operators of the hotel capitalized the cost of the improvements but claimed expense deductions for the cost of painting and repapering rooms. The IRS disallowed the deductions, claiming they were part of the improvement program. The operators claimed that the papering and painting were normal and usual maintenance work required to keep the hotel in first-class condition. The Tax Court disagreed and sided with the IRS. However, on appeal, the appeals court allowed the deduction. The "rehabilitation doctrine" does not apply where it can be shown that repairs are part of a normal range of ongoing maintenance. Here, the painting and papering only served to maintain the first-class status of the hotel. The fact that the work was done under a general improvement plan does not defeat the deduction. Any commercial enterprise, such as a hotel, that annually spends large sums of money on replacements and repairs must do so under a detailed plan and budget.

How To Report Rentals of Residential and Vacation Homes

¶9.4 Reporting Rents From a Multi-Unit Residence

If you rent out an apartment or room in a multi-unit residence in which you also live, you report rent receipts and deduct expenses allocated to the rented part of the property on Schedule E of Form 1040. Expenses allocated to rental are deductible, whether or not you itemize deductions. You deduct interest and taxes on your personal share of the property as itemized deductions if you itemize deductions.

If expenses exceed rental income on Schedule E, your loss deduction is subject to the passive loss rules of Chapter 10. The loss, if it comes within the $25,000 allowance (¶10.2) or the exception for real estate professionals (¶10.3), may be deducted from any type of income. If you cannot claim the allowance, the loss may be deducted only from passive activity income.

If your only passive activity losses are rental losses of $25,000 or less from actively managed rental real estate and your modified adjusted gross income is $100,000 or less, you do not have to use Form 8582 to deduct losses under the $25,000 allowance; *see* ¶10.12.

EXAMPLE

You bought a three-family house in 1973. You occupy one apartment as a personal residence. The house cost you $30,000 ($27,000 for the building and $3,000 for the land). It had a useful life of 30 years. Two-thirds of the basis of the building has been subject to depreciation, or $18,000 (⅔ of $27,000). Assuming straight-line depreciation of $600 ($18,000 cost ÷ 30 years), this is how you deduct expenses in a taxable year:

	Total	*Deduct itemized deductions*	*Deduct on Schedule E*	*Not deductible*
Taxes	$ 600	$200	$ 400	
Interest	390	130	260	
Repairs	300		200	$100
Depreciation	600		600	
	$1,890	$330	$1,460	$100

The taxes and interest allocated to personal use are deductible on Schedule A if you itemize deductions. Repairs allocated to your apartment are nondeductible personal expenses.

If you or close relatives personally use the rented portion during the year and expenses exceed income, loss deductions may be barred under the rules of ¶9.7.

¶9.5 Depreciation on Converting a Home to Rental Property

When you convert your residence to rental property, you may depreciate the building. You figure depreciation on the *lower* of:

- Fair market value of the building at the time you convert it to rental property; and
- Adjusted basis. This is your original cost for the building, exclusive of land, plus permanent improvements minus casualty or theft loss deductions claimed on prior tax returns.

You claim MACRS depreciation based on a 27½-year recovery period. The specific rate for the year of conversion is the rate for the month in which the property is ready for tenants. For example, you move out of your home in May and make some minor repairs. You advertise the house for rent in June. Depreciation starts in June because that is when the home is ready for rental, even if you do not actually obtain a tenant until a later month. Under a mid-month convention, the house is treated as placed in service during the middle of the month. This means that one-half of a full month's depreciation is allowed for that month. In the table below, the monthly depreciation rates for the year the property is placed in service and the next eight years are shown. The table incorporates the mid-month convention.

EXAMPLE

In 1986, you bought a house for $125,000, of which $100,000 is allocated to the house; the $25,000 balance is allocated to the land. In June 1996 you move out of the house and rent it. At that time, the fair market value of the house exclusive of the land is $150,000. The depreciable basis of the house is the lower adjusted basis of $100,000. The depreciation rate for placing the house in service in June is 1.970%, as shown in the table below. Thus, your 1996 depreciation deduction is $1,970 ($100,000 × 1.970%).

Depreciating a rented cooperative apartment. If you rent out a co-op apartment, you may deduct your share of the total depreciation claimed by the cooperative corporation. The method for computing your share depends on whether you bought your co-op shares as part of the first offering. If you did, follow these steps: (1) Ask the co-op corporation officials for the total real estate depreciation deduction of the corporation, not counting depreciation for office space that cannot be lived in by tenant-shareholders. (2) Multiply Step 1 by the following fraction: number of your co-op shares divided by total shares outstanding. The result is your share of the co-op's depreciation, but you may not deduct more than your adjusted basis.

The computation is more complicated if you bought your co-op shares after the first offering. You must compute your depreciable basis as follows. Increase your cost for the co-op shares by your share of the co-op's total mortgage. Reduce this amount by your share of the value of the co-op's land and your share of the commercial space not available for occupancy by tenant-stockholders. Your "share" of the co-op's mortgage, land value, or commercial space is the co-op's total amount for such items multiplied by the fraction in Step 2, that is, the number of your shares divided by the total shares outstanding. After computing your depreciable basis, multiply that basis by the depreciation percentage for the month your apartment is ready for rental.

Basis to use when you sell a rented residence. For purposes of figuring gain, you use adjusted basis at the time of the conversion, plus subsequent capital improvements, and minus depreciation and casualty loss deductions. For purposes of figuring loss, you use the *lower* of adjusted basis or fair market value at the time of the conversion, plus subsequent improvements and minus depreciation and casualty losses. You may have neither gain nor loss to report; this would happen if you figure a loss when using the above basis rule for gains, and you figure a gain when using the basis rule for losses.

Have an appraiser estimate the fair market value of the house when it is rented. The appraisal will help support your basis for depreciation or a loss deduction on a sale if your return is examined.

First-Year Depreciation: Use the Month of Taxable Year Residence Is Ready for Rental

Year	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485%	3.182%	2.879%	2.576%	2.273%	1.970%	1.667%	1.364%	1.061%	0.758%	0.455%	0.152%
2–9	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
10	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
11	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
12	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636

Depreciation on a vacant residence. If you move from your house before it is sold, you generally may not deduct depreciation on the vacant residence while it is held for sale. The IRS will not allow the deduction, and, according to a Tax Court case, a deduction is possible only if you can show that you held the house, expecting to make a profit on an increase in value over and above the value of the house when you moved from it. That is, you held the house for sale on the expectation of profiting on a future increase in value after abandoning the house as a residence.

¶9.6 Renting to a Relative

The tax law distinguishes between a rental of a unit used by a close relative as a principal residence, and a rental of a unit that is not the relative's principal residence, such as a second home or vacation home. It is easier to deduct a rental loss on the principal residence rental.

On a fair market rental of a unit used by the close relative as a principal residence, your relative's use is *not* considered personal use by you that could bar a loss under the personal-use test of ¶9.7. A relative's use of the unit as a second or vacation home *is* attributed to you in applying the personal-use test at ¶9.7, even if you receive a fair market value rent.

Close relatives who come within these rules are: brothers and sisters, half-brothers and half-sisters, spouses, parents, grandparents, children, and grandchildren.

Fair market rental is the amount a person who is not related to you would be willing to pay. The most direct way to determine fair market rental is to ask a real estate agent in your neighborhood for comparative rentals.

¶9.7 Personal Use and Rental of a Residential Unit During the Year

The number of days of personal and rental use determines how you must report income and expenses of a residential unit in which you live part of a taxable year and rent or offer for rent for the days you do not live there.

Before reading the daily-use tests, list your days of use in 1996:

Fair market rental days:_____________

Personal-use days:_________________

Personal-use days may also include rental days to family members listed at ¶9.6 and use days under co-ownership agreements. *See* ¶9.8 for details on personal-use days.

Rental of less than 15 days during the taxable year. If rent days are less than 15 days in the taxable year, you do not report the rental income and the only deductions allowed are those you would be allowed anyway as a homeowner. That is, if you itemize deductions on Schedule A, you deduct mortgage interest, real estate taxes, and casualty losses, if any. No other rental expenses such as depreciation and maintenance expenses are deductible. Interest is generally fully deductible if the home qualifies as a first or second home under the mortgage interest rules of Chapter 15.

Rental of 15 days or more in the taxable year. A daily-use test determines whether your use of the unit during the taxable year is treated as residential use which requires you to figure your deductions under the allocation rules of ¶9.9 that limit your deductions to the rental income. You are considered to have used the unit as a residence if personal-use days exceed the *larger* of 14 days and 10% of fair market rental days. When the unit is treated as a residence, rental expenses are deductible on Schedule E only to the extent of rental income, following the rules of ¶9.9. Expenses not deductible in the current year under this limitation may be carried forward and will be deductible up to rental income in the following year. The deduction limit is irrelevant if your rental income exceeds expenses. You report the rental income and claim the deductible expenses on Schedule E.

If your personal-use days do not exceed the larger of 14 days and 10% of the fair market rental days, your rental deductions are not limited by the personal-use test. However, a loss deduction is subject to the passive activity loss restrictions discussed at ¶10.1.

EXAMPLES

1. In 1996, you rented out a condominium unit in Florida at a fair market rental for 260 days. If you used the unit personally for 27 or more days, the condominium is considered a residence subject to the allocation rules of ¶9.9 because your personal use exceeds 26 days, 10% of the fair market rental days. If you used the unit for 26 days or less, you may treat the unit for the taxable year as rental property and you may deduct a loss, if any, subject to the passive activity rules of ¶10.1.

   Where rental days exceed 140 days, as a rule of thumb, you can figure that for every 10 days of fair-rent use, you may use the unit personally for one day. Thus, if you rented a vacation unit for 11 months, you could personally use it for a month or so without jeopardizing a deduction of a rental loss (rental of 330 days would permit 33 days of personal use).
2. Assume the same unit as in Example 1 but you rented the unit for 130 days. If you used the unit personally for 14 days or less, you may treat the unit as a rental property. To be treated as a residence, your personal use would have to exceed 14 days, since 14 days is greater than 10% of the rental days.

The daily-use tests apply to any "dwelling unit" you rent out which is also used as a residence during the year by yourself or other family members. A dwelling unit may be a house, apartment, condominium, cooperative, house trailer, mini motor home, boat, or similar property, including any appurtenant structure such as a garage. Any dwelling unit is used exclusively as a hotel, motel, inn, or similar establishment.

¶9.8 Counting Personal-Use and Rental Days

In applying the personal-use test of ¶9.7, personal-use days are:

- Days you used the residence for personal purposes other than days primarily spent making repairs or getting the property ready for tenants.
- Days on which the residence is used by your spouse, children, grandchildren, parents, brothers, sisters, or grandparents. However, if such a relative pays you a fair rental value to use the home as a *principal* residence, the relative's use is not considered personal use by you. If you rent a vacation home to such relatives, their use is considered personal use by you even if they pay a fair rental value amount.
- Days on which the residence is used by any person under a reciprocal arrangement that allows you to use some other dwelling during the year.
- Days on which you rent the residence to any person for less than fair market value.
- Days that a co-owner of the property uses the residence, unless the co-owner's use is under a shared-equity financing agreement discussed later in this section.

An owner is not considered to have personally used a home that is used by an employee if the value of such use is tax-free lodging required as a condition of employment; *see* ¶3.11.

Shared-equity financing agreements for co-owners. Use by a co-owner is not considered personal use by you if you have a shared-equity financing agreement under which: (1) the co-owner pays you a fair rent for using the home as his or her principal residence; and (2) you and your co-owner each have undivided interests for more than 50 years in the entire home and in any appurtenant land acquired with the residence.

Any use by a co-owner which does not meet these two tests is considered personal use by you if, for any part of the day, the home is used by a co-owner or a holder of any interest in the home (other than a security interest or an interest under a lease for fair rental) for personal purposes. For this purpose, any other ownership interest existing at the time you have an interest in the home is counted, even if there are no immediate rights to possession and enjoyment of the home under such other interest. For example, you have a life estate in the home and your friend owns the remainder interest. Use by either of you is personal use.

EXAMPLES

1. A son rented a condominium in Florida to his parents, who split their time between the Florida apartment and the home they owned in Illinois. Although the parents paid a fair amount for the Florida condo, the son's rental deductions were limited by the IRS and the Tax Court to interest and real estate taxes that did not exceed the rental income. The parents' rental days were attributed to the son under the 14 day/10% rental day limit since the home in Illinois, and not the Florida apartment, was their principal residence.
2. You and your neighbor Joe are co-owners of a vacation condominium. You rent the unit out whenever possible; Joe uses the unit for two weeks every year. As Joe owns an interest in the unit, both of you are considered to have used the unit for personal purposes during those weeks.
3. You and your neighbor Tom are co-owners of a house under a shared-equity financing agreement. Tom lives in the house and pays you a fair rental price. Even though Tom has an interest in the house, the days he lives there are not counted as days of personal-use by you because Tom rents the house as a main home under a shared-equity financing agreement.
4. You rent a beach house to Jane. Jane rents her house in the mountains to you. You each pay a fair rental price. You are using your house for personal purposes on the days that Jane uses it because your house is used by Jane under an arrangement that allows you to use her house.

Shared-Equity Financing Agreements

As an investor, you can help finance the purchase of a principal residence for a family member or other individual. The rental income you receive for your ownership share in the property may be offset by deductions for your share of the mortgage interest, taxes, and operating expenses you pay under the terms of the agreement, as well as depreciation deductions for your percentage share. Rental losses are subject to the passive loss restrictions of Chapter 10.

The other co-owner living in the house may claim itemized deductions for payment of his or her share of the mortgage interest and taxes.

Rental of principal residence prior to sale. You are not considered to have made any personal use of a principal residence which you rent or try to rent at a fair rental for (1) a consecutive period of 12 months or more, *or* (2) for a period of less than 12 months that ends with the sale or exchange of the residence. For example, you move out of your principal residence on May 31, 1997, offering it

for rental as of June 1. You rent it from June 15 until mid-November, when you sell the house. Under the special rental period rule, your use of the house from January 1 until May 31, 1997, is *not* counted as personal use. This means that deductions for the rental period are not subject to the allocation rules and restrictions of ¶9.9.

Rental pool arrangements. Pool arrangements have been devised to avoid the loss restriction by attempting to increase the days the home is held for a fair rental value. They have not been successful. Courts have ruled that only days on which a home is actually rented count as fair rental days, not days of availability through the rental pool.

In proposed regulations, the IRS also holds that a rental pool is not a basis for counting fair rental days. However, the proposed regulations permit rental pool participants to elect to average the actual rental of their units. Unanimous consent is required to elect the averaging rule. If the election is made, the number of rental days for a unit is determined by multiplying the aggregate number of days that all units in the rental pool were rented at fair rental during the pool season by a fraction. The numerator of the fraction is the number of participation days of a particular unit; the denominator is the aggregate number of participation days of all the units.

The IRS may apply the rental pool rule to a rental guarantee option. The Tax Court supported the IRS position, but an appeals court did not, in the following Example.

EXAMPLE

Razavi owned a condo in Florida and elected to take a rental guarantee option from the resort operator over a three-year period. The annual guaranteed rent was $21,000 plus 40% of rentals over $52,500. In 1987, the resort actually received gross rentals of $48,300 for the unit, but Razavi received $21,000 under the guarantee and claimed a rental loss deduction. The IRS disallowed the loss because it claimed that Razavi personally used the unit for 27 days, exceeding 10% of the 200 days the unit had actually been rented.

Razavi claimed that the 27 days were less than 10% of the 338 days covered by a rental guarantee. That is, the guarantee covered 365 days less 27 days of personal use. The Tax Court disagreed on the grounds that the guarantee was based on a rental period of between 142 days and 179 days and this was far below the 270 rental days needed to support his 27 personal-use days.

The Sixth Circuit allowed the loss. The $21,000 guarantee was a fair rental for the entire year based on rentals of comparable units. Although Razavi probably could have earned more than $21,000 with daily or weekly rentals, such short-term rentals also would have carried added risks and responsibilities that he was able to avoid by choosing the rent guarantee.

¶9.9 Allocating Expenses to Rental Days

When you personally use a home on any day during the taxable year, expenses are allocated between personal and rental use. By law, deductible expenses of renting are limited by this fraction:

$$\frac{\text{Days of fair rental}}{\text{Total days of rental and personal use}}$$

The number of days a vacation home is held out for rent but not actually rented is not counted as rental days.

There is a conflict of opinion between the IRS and the courts over the issue of whether this formula applies also to interest and taxes. According to the courts, interest and taxes are allocated on a daily basis. Thus, if a house is rented for 61 days in the year, one-sixth of the deductible interest and taxes (61/365) is deducted first from the rental income. This rule allows a larger amount of other expenses to be deducted from rental income; *see* Example 2 on the next page.

Claiming expenses if personal use bars a loss deduction. If expenses allocated to rental exceed rental income and your personal use exceeds the 14-day/10% test of ¶9.7, the allocated rental expenses are deducted from rental income in a specific order. First, gross rental income is reduced by otherwise deductible interest and taxes allocated to the rental activity. Second, the remaining income is reduced by expenses not related to the property itself, such as office supplies, rental agency fees, and advertising. Next, operating expenses (other than depreciation) such as utilities, repairs, and insurance are deducted to the extent of remaining rental income. Finally, if there is any rental income remaining, depreciation may be deducted up to the balance of income.

Rental expenses in excess of rental income are carried forward to the next year. In the next year, you can deduct the carried-over expenses only to the extent of rental income, even if your personal use does not exceed the 14-day/10% test for that year.

EXAMPLES

1. You rent out your vacation home for 61 days in 1996, receiving rent of $2,000. You use it yourself for 61 days. You may deduct expenses only up to the amount of this income because your personal use exceeds the 14-day/10% rental test. Your expenses are mortgage interest of $1,600, real estate taxes of $800, and maintenance and utility costs of $1,200. Depreciation (based on 100% rental use) is $1,500. Assume the vacation home is a qualifying second home (¶15.1), so that all the interest is deductible under the mortgage interest rules. Under the IRS method, one-half of all the expenses (61 rental days divided by 122 total days of use), including the interest and taxes, are deducted in this order:

Rent income		$2,000
Less: Interest	$800	
Taxes	400	1,200
		$ 800
Less: Maintenance		600
		$ 200
Less: Depreciation		$ 200

Under the Tax Court's method of allocating interest and taxes, one-sixth of the interest and taxes (61/365) would be deducted from rental income, rather than one-half as under the IRS method.

The balance of the depreciation is not deductible. It may be carried forward to the following year.

The balance of interest and taxes is deductible as itemized deductions provided you claim itemized deductions on Schedule A of Form 1040.

If the vacation home were not a qualifying second residence under ¶15.1, the interest would not be deducted with taxes from the $2,000 of rental income, but would be treated as an operating expense and deducted along with the maintenance expenses.

2. The Boltons paid interest and property taxes totaling $3,475 on their vacation home. Maintenance expenses (not including depreciation) totaled $2,693. The Boltons stayed at the home 30 days and rented it for 91 days, receiving rents of $2,700. Because the personal use for 30 days exceeded the 14-day limit, the Boltons could deduct rental expenses only up to the gross rental income of $2,700, reduced by interest and taxes allocable to rental. In figuring the amount of interest and taxes deductible from rents, they divided the number of rental days, or 91, by 365, the number of days in the year. This gave them an allocation of 25%. After subtracting $868 for interest and taxes (25% of $3,475) from rental income, they deducted $1,832 ($2,700 – $868) of maintenance expenses from rental income.

The IRS argued that 75% of the Boltons' interest and tax payments had to be allocated to the rental income. The IRS used an allocation base of 121 days of personal and rental use. Thus, the IRS allocated 75% (91/121) of the interest and taxes, or $2,606, to gross rental income of $2,700. This allocation allowed only $94 maintenance expenses to be deducted ($2,700 – $2,606).

The Tax Court sided with the Boltons and an appeals court (the Ninth Circuit) agreed. The IRS method of allocating interest and taxes to rental use is bizarre. Interest and taxes are expenses that accrue ratably over the year and are deductible even if a vacation home is not rented for a single day. Thus, the allocation to rental use should be based on a ratable portion of the annual expense by dividing the number of rental days by the number of days in a year.

The Tenth Circuit appeals court also supports the Tax Court allocation method.

Interest expenses. If you personally use a rental vacation home for more than the greater of 14 days and 10% of the rental days, the residence may be treated as a qualifying second residence under the mortgage interest rules; *see* ¶15.1. The interest on a qualifying second home is generally fully deductible and is not subject to disallowance under the passive activity restrictions of Chapter 10. In figuring deductible rental expenses, the portion of the deductible mortgage interest allocable to the rental portion is deducted from rental income (along with taxes) before other expenses.

¶9.10 Rentals Lacking Profit Motive

When a rental of a residential unit does not come within the personal-use limitation of ¶9.7, the IRS may attempt to disallow a loss by claiming that you had no profit motive in placing the unit up for rent. If the IRS makes such an argument, you must try to prove a profit motive under ¶40.9. Any loss disallowed under these grounds may not be carried over to a later year.

EXAMPLES

1. *(Loss allowed.)* In 1973, Clancy purchased a house and land in a coastal resort area of California. Prior to the purchase, Clancy was told by a renting agent that he could expect reasonable income and considerable appreciation from the property. Previously, he had sold similar property in the same development at a profit. After the purchase, Clancy spent $5,000 to prepare the house for rental, and gave a rental agency the exclusive right to offer the property for rent. The house was available for rent 95% of the time in 1973, and 100% of the time in 1974. However, rentals proved disappointing, totaling only $280 in 1973 and $1,244 in 1974, despite the active efforts of the agency to rent the property. However, the house did appreciate in value and was eventually sold at a profit of $14,000. In 1973 and 1974, Clancy deducted rental expenses of approximately $21,000 which the IRS disallowed. The IRS claimed that the house was not rental property used in a business. Furthermore, as Clancy knew that he could not make a profit from the rentals, he could not be considered to hold the property for the production of income.

The Tax Court agrees that the expenses are not deductible business expenses. But this does not mean that they are not deductible as expenses of income production. Although the rental income from the property was minimal, Clancy acquired and held the property expecting to make a profit on a sale. He had previously sold similar property at a profit and was told to expect considerable rental income as well as appreciation from the new house. Where an owner holds property, as Clancy did here, because he believed that it may appreciate in value, such property is held for the production of income. Further evidence that Clancy held the property to make a profit: He rarely used it for personal purposes and an agent actively sought to rent it.

2. *(Loss allowed.)* Nelson bought a condominium, hired a rental agent, and even advertised in the *Wall Street Journal* and *Indianapolis Star*. He also listed the unit for sale. During 1974, he was unable to rent the apartment but deducted expenses and depreciation of over $6,100, which the IRS disallowed. The IRS argued that he did not buy the unit to make a profit but to shelter substantial income from tax. The Tax Court disagreed. Although his efforts to rent were not successful in 1974, he was successful in later years in renting the unit. He rarely visited the apartment other than to initially furnish it. When he went on vacation, he went abroad or to other vacation spots.

3. *(Loss disallowed.)* The Lindows purchased a condominium which they rented out during the prime winter rental season. However, over an eight-year period their expenses consistently exceeded rental income. The Tax Court agreed with the IRS that expenses in excess of rental income were not deductible. Substantial, repeated losses, even after the initial years of operation, indicate that the operation was not primarily profit-oriented. The rental return during the prime rental season could not return a profit. Even if the condominium were fully rented for the entire prime rental season, annual claimed expenses would exceed rent income. The couple also used the unit for several months and intended to live there on retirement. They did not consider putting the unit up for sale with an agent. Finally, that they had detailed records of income and expenses did not prove a business venture. Records, regardless of how detailed, are insufficient to permit the deduction of what are essentially personal expenses.

IRS may challenge losses claimed on temporary rental before sale. If you are unable to sell your home and must move, it may be advisable to put it up for rent. This way you may be able to deduct maintenance expenses and depreciation on the unit even if it remains vacant. However, the IRS has disallowed loss deductions for rentals preceding a sale on the ground that there was no "profit motive" for the rental under the rules of ¶40.9. Courts have allowed loss deductions in certain cases.

EXAMPLES

1. The IRS and Tax Court disallowed a loss deduction for rental expenses under the "profit-motive rules" (¶40.9) where a principal residence was rented for 10 months until it could be sold. According to the Tax Court, the temporary rental did not convert the residence to rental property. Since the sales effort was primary, there was no profit motive for the rental. Thus, no loss could be claimed; rental expenses were deductible only to the extent of rental income. The favorable side of the Tax Court position: Since the residence was not converted to rental property, the owners could defer tax on the gain from the sale by buying a new home. An appeals court reversed the Tax Court and allowed both tax deferral and a loss deduction. The rental loss was allowed since the old home was actually rented for a fair rental price. Furthermore, the owners had moved and could not return to the old home, which was rented almost continuously until sold.
2. In 1976, a couple bought a condo apartment in Pompano Beach, Florida. In 1983, they decided to move and listed the unit for either sale or rent with a local real estate broker. Sale of the unit was difficult because of the saturation of the Florida real estate market. Rental of the unit was also difficult because the condominium association's rules barred the rental of condominium units on a seasonal basis. The unit remained unrented until it was sold in 1986 for a substantial gain. In 1984, the couple deducted a $9,576 rental loss ($7,596 for maintenance expenses and $1,980 for depreciation). The IRS disallowed the deduction as not incurred in a bona fide rental activity. The Tax Court allowed the deduction. The couple made an honest and reasonable effort to rent the condominium. Lack of rental income was caused by a slack rental market and the condominium association rules prohibiting short-term rentals.

Royalty Income and Deductions

¶9.11 Reporting Royalty Income

Royalties are payment for use of patents or copyrights or for the use and exhaustion of mineral properties. Royalties are taxable as ordinary income and are reported on Schedule E (Form 1040). Depletion deductions relating to the royalties are also reported on Schedule E. If you own an operating oil, gas, or mineral interest, or are a self-employed writer, investor, or artist, you report royalty income, expenses, and depletion on Schedule C.

EXAMPLES OF ROYALTY INCOME—

License fees received for use, manufacture, or sale of a patented article.
Renting fees received from patents, copyrights, and depletable assets (such as oil wells).
Authors' royalties including advance royalties if not a loan.
Royalties for musical compositions, works of art, etc.
Proceeds of sale of part of your rights in an artistic composition or book—for example, sale of motion picture or television rights.
Royalties from oil, gas, or other similar interests; *see* ¶9.16. To have a royalty, you must retain an economic interest in the minerals deposited in the land which you have leased to the producer. You usually have a royalty when payments are based on the amount of minerals produced. However, if you are paid regardless of the minerals produced, you have a sale which is taxed as capital gain if the proceeds exceed the basis of the transferred property interest. Bonuses and advance royalties which are paid to you before the production of minerals are taxable as royalty income and are entitled to an allowance for depletion. However, bonuses and advanced royalties for gas and oil wells and geothermal deposits are not treated as gross income for purposes of calculating percentage depletion. If the lease is terminated without production and you received a bonus or advanced royalty, you report as income previously claimed depletion deductions. You increase the basis of your property by the restored depletion deductions.

Passive income. Certain working oil and gas interests are not subject to passive activity loss rules; *see* ¶10.10.

¶9.12 Production Costs of Books and Creative Properties

Freelance authors, artists, and photographers may deduct their costs of producing original works in the years that the expenses are paid or incurred. The uniform capitalization rules that generally apply to property that you produce (*see* ¶40.2) do not apply.

You qualify for current expense deductions if you are self-employed and you *personally create* literary manuscripts, musical or dance scores, paintings, pictures, sculptures, drawings, cartoons, graphic designs, original print editions, photographs, or photographic negatives or transparencies.

If you conduct business as an owner-employee of a personal service corporation, and you are a qualifying author, artist, or photographer, the corporation may claim current deductions related to your expenses in producing books or other eligible creative works. Substantially all of the corporation's stock must be owned by you and your relatives.

CAUTION

Photographers and Filmmakers

Current deductions are *not allowed* for expenses relating to motion picture films, videotapes, printing, photographic plates, or similar items.

Hobby loss restrictions. Authors and artists with expenses exceeding income may be barred by the IRS from claiming loss deductions; *see* ¶40.9.

¶9.13 Deducting the Cost of Patents or Copyrights

If you create an artistic work or invention for which you get a government patent or copyright, you may depreciate your costs over the life of the patent or copyright. Basis for depreciation includes all expenses which you are required to capitalize in connection with creating the work such as the cost of drawings, experimental models, stationery, and supplies; travel expenses to obtain material for a book; fees to counsel; government charges for patent or copyright; and litigation costs in protecting or perfecting title.

If you purchased the patent or artistic creation, depreciate your cost over the remaining life of the patent or copyright. If your cost for a patent is payable annually as a fixed percentage of the revenue derived from use of the patent, the depreciation deduction equals the royalty paid or incurred for that year. However, if a copyright or patent is acquired in connection with the acquisition of a business, the cost is amortizable over a 15-year period as a Section 197 intangible; see ¶42.13.

If you inherited the patent or rights to an artistic creation, your cost is the fair market value either at the time of death of the person from whom you inherited it (¶5.21) or the alternate valuation date if elected by the executor (¶39.4). You get this cost basis even if the decedent paid nothing for it. Figure your depreciation by dividing the fair market value by the number of years of remaining life.

If your patent or copyright becomes valueless, you may deduct your unrecovered cost or other basis in the year it became worthless.

¶9.14 Intangible Drilling Costs

Intangible drilling and development costs include wages, fuel, repairs, hauling, and supplies incident to and necessary for the preparation and drilling of wells for the production of oil or gas, and geothermal wells. For wells you are developing in the United States, you can elect to deduct the costs currently as business expenses or treat them as capital expenses subject to depreciation or depletion.

Electing current deductions. The election applies only to costs of drilling and developing items that do not have a salvage value. You must make this election by deducting the expenses on your income tax return for the first tax year in which you pay or incur the costs.

Tax-shelter investors may deduct prepayments of drilling expenses only if the well is "spudded" within 90 days after the close of the taxable year in which the prepayment is made. The prepayment must also have a business purpose, not be a deposit, and not materially distort income. The investor's deduction is limited to his or her cash investment in the tax shelter. For purposes of this limitation, an investor's cash investment includes loans that are not secured by his or her shelter interest or the shelter's assets and loans that are not arranged by the organizer or promoter. If the above tests are not met, a deduction may be claimed only as actual drilling services are provided.

Recapture of intangible drilling costs for oil, gas, geothermal, or mineral property. Upon the disposition of oil, gas, geothermal, or other mineral property placed in service after 1986, ordinary income treatment applies to previously claimed deductions for intangible drilling and development costs for oil, gas, and geothermal wells, and to mineral development and exploration costs. Depletion deductions under ¶9.15 are also generally subject to this ordinary income treatment upon disposition of the property.

For oil, gas, or geothermal property placed in service before 1987, ordinary income treatment applies on the disposition of a working or operating interest to the extent that intangible drilling and development cost deductions exceeded what would have been allowed if the costs had been deducted through cost depletion. Recapture for geothermal property applies only to wells commenced after September 30, 1978.

AMT and intangible drilling costs. If you are an independent oil or gas producer or royalty owner, intangible drilling costs for oil and gas production are not treated as tax preference items for purposes of alternative minimum tax (AMT). However, the reduction in your AMT income from not treating intangible drilling costs as a tax preference is limited. The reduction may not exceed 40% of your AMT income, figured as if excess intangible drilling costs were still a tax preference item and without regard to any AMT net operating loss deduction; *see* ¶23.5.

¶9.15 Depletion Deduction

Properties subject to depletion deductions are mines, oil and gas wells, timber, and exhaustible natural deposits.

Two methods of computing depletion are: (1) cost depletion; and (2) percentage depletion. If you are allowed to compute under either method, you must use the one that produces the *larger* deduction. In most cases, this will be percentage depletion. For timber, you must use cost depletion.

Cost depletion. The cost depletion of minerals is computed as follows: (1) divide the total number of units (tons, barrels) remaining in the deposit to be mined into the adjusted basis of the property; (2) multiply the unit rate found in Step 1 by the number of units for which payment is received during the taxable year if you are on the cash basis, or the units sold if you are on the accrual basis.

Adjusted basis is the original cost of the property, less depletion allowed, whether computed on the percentage or cost depletion method. It does not include nonmineral property such as mining equipment. Adjusted basis may not be less than zero.

Timber depletion is based on the cost of timber (or other basis in the owner's hands) and does not include any part of the cost of land. Depletion takes place when standing timber is cut. Depletion must be computed by the cost method, not by the percentage method. However, instead of claiming the cost depletion method, you may elect to treat the cutting of timber as a sale subject to capital gain or loss treatment. For further details, *see* IRS Publication 535.

Percentage depletion. Percentage depletion is based on a certain percentage rate applied to annual gross income derived from the resource. In determining gross income for percentage depletion, do not include any lease bonuses, advance royalties, or any other amount payable without regard to production. A deduction for percentage depletion is allowed even if the basis of the property is already fully recovered by prior depletion deductions. The percentage to be applied depends upon the mineral involved; the range is from 5% up to 22%. For example, the maximum 22% depletion deduction applies to sulphur, uranium, and U.S. deposits of lead, zinc, nickel, mica, and asbestos. A 15% depletion percentage applies to U.S. deposits of gold, silver, copper, iron ore, and shale. For timber, cost depletion must be used.

Note: As an independent oil or gas producer, or royalty owner, you do not have to treat a portion of your depletion deduction as a preference item for AMT purposes; *see* ¶23.5.

Taxable income limit. For properties other than oil and gas, the percentage depletion deduction *may not exceed* 50% of taxable income from the property computed without the depletion deduction. In computing the 50% limitation, a net operating loss deduction is not deducted from gross income. A 100% taxable income limit applies to oil and gas properties; *see* ¶9.16.

Oil and gas property. Percentage depletion for oil and gas wells was repealed as of January 1, 1975, except for the following exemptions: (1) small independent producers and royalty owners; and (2) for gas well production. These oil and gas percentage depletion exemptions are discussed at ¶9.16.

¶9.16 Oil and Gas Percentage Depletion

Small independent producers and royalty owners generally are allowed to deduct percentage depletion at a 15% rate for domestic oil and gas production. However, a higher rate may be allowed for qualifying "marginal" production, as discussed on the next page. The deduction is subject to a taxable income limit.

The 15% rate applies to a small producer exemption which equals the gross income from a maximum daily average of 1,000 barrels of oil or 6 million cubic feet of natural gas, or a combination of both. Gross income from the property does not include advanced royalties or lease bonuses that are payable without regard to the actual production.

The depletable natural gas quantity depends on an election made annually by independent producers or royalty owners to apply part of their 1,000-barrel-per-day oil limitation to natural gas. The depletable quantity of natural gas is 6,000 cubic feet times the barrels of depletable oil for which an election has been made. The election is made on an original or amended return or on a claim for credit or refund. For example, if your average daily production is 1,200 barrels of oil and 6.2 million cubic feet of natural gas, your maximum depletable limit is 1,000 barrels of oil, which you may split between the oil and gas. You could claim depletion for 500 barrels of oil per day and for 3 million cubic feet of gas per day: 3 million cubic feet of gas is the equivalent of the remaining 500 barrels of oil limit (500 barrels × 6,000 cubic feet depletable gas quantity equals 3 million cubic feet of gas).

Transferees who received their interest in a "proven" oil or gas property after October 11, 1990 are allowed percentage depletion under the regular rules.

Transferees receiving "proven" properties after 1974 and before October 12, 1990, are not allowed percentage depletion *unless* the transfer was made because of the death of the prior owner, a tax-free transfer to a controlled corporation, a transfer between commonly-controlled corporations, or changes in beneficiaries of a trust where the changes are due to births, adoptions, or deaths within a single family.

Ineligible retailers and refiners. The small producer exemption is not allowed to any producer who owns or controls a retail outlet for the sale of oil, natural gas, or petroleum products. It is also not allowed to a refiner who refines more than 50,000 barrels of oil on any one day of the taxable year; the limit is based on inputs of crude oil into the refinery process, rather than outputs. A taxpayer is not treated as a retailer where gross sales of oil and gas products are less than $5 million in any one year or if all sales of oil or natural gas products occur outside the United States, and none of the taxpayer's domestic production is exported. Bulk sales of oil or natural gas to industrial or utility customers are not to be treated as retail sales.

Figuring average daily domestic production. Average daily production is figured by dividing your aggregate production during the taxable year by the number of days in the taxable year. If you hold a partial interest in the production (including a partnership interest), production rate is found by multiplying total production of such property by your income percentage participation in such property.

The production over the entire year is averaged regardless of when production actually occurred. If average daily production for the year exceeds the 1,000-barrel or 6-million-cubic-feet limit, the exemption must be allocated among all the properties in which you have an interest.

Taxable income limits on percentage depletion. The percentage depletion deduction for a small producer or royalty owner may not exceed the *lesser* of (1) 100% of the taxable income from the property before the depletion allowance, and (2) 65% of your taxable income from all sources computed without regard to the depletion deduction allowed under the small producer's exemption, any net operating loss carry-back, and any capital loss carry-back.

100% taxable income limit. To encourage investments in marginally producing properties, Congress raised the deduction limit from 50% to 100% of taxable income from the property for tax years starting after 1990.

Limitations where family members or related businesses own interests. The daily exemption rate is allocated among members of the same family in proportion to their respective production of oil. Similar allocation is required where business entities are under common control. This affects interests owned by you, your spouse, and minor children; by corporations, estates, and trusts in which 50% of the beneficial interest is owned by the same or related persons; and by a corporation which is a member of the same controlled group.

Higher depletion for marginal production. Independent producers and royalty owners are allowed a higher depletion rate for *marginal production*, defined as oil or natural gas from "stripper well property" or property producing substantially all "heavy" oil. A stripper well property is one from which average daily production, divided by the number of all producing wells on the property, is 15 or less "barrel equivalents." A barrel equivalent is a barrel of oil or 6,000 cubic feet of natural gas.

The 15% rate is increased by 1% for each whole dollar that the "reference price" (the average annual wellhead price as estimated by the IRS) of domestic crude oil for the previous year was below $20 per barrel. For example, the IRS determined that the reference price for 1995 was $14.26, so the allowable depletion rate for qualifying production in 1996 is 20%, a 5% increase over the 15% floor (the excess of $20 over $14.26, or $5.74, is limited to the whole dollar excess of $5). The maximum annual depletion rate as a result of the increase is 25%, which would be allowed only if the previous year's reference price was $10 per barrel.

The higher rate applies only up to the maximum depletable limit, which is the average daily production of up to 1,000 barrels a day of oil, or 6 million cubic feet of gas. If the taxpayer has production from "marginal properties" eligible for the higher depletion rate, as well as production from other properties subject to the 15% rate, the marginal production is taken into account first in applying the 1,000-barrel or 6-million-cubic-feet overall limit. However, a special election may be made to prorate the overall limit among all production, whether marginal or nonmarginal.

22% rate for certain natural gas. The 22% depletion allowance is allowed only for domestic natural gas sold under a fixed contract in effect on February 1, 1975.

Partnerships and S corporations. For partnership property, cost or percentage depletion is figured separately by each partner and not by the partnership. However, the partnership first allocates to each partner his or her share of the adjusted basis of each partnership oil or gas property. The partner's share of the adjusted basis depends on his or her interest in partnership capital or income, or is determined by the partnership agreement. A partner reduces his or her share of the adjusted basis of each property by the amount of depletion claimed each year.

The partner reports the share of royalty income and deducts depletion on Schedule E. Each interest in a partnership is reported separately.

Each stockholder of an S corporation figures the depletion allowance separately in the same way as a partner in a partnership. The S corporation allocates to each shareholder his or her basis of each oil or gas property held by the corporation.